Department of the Treasury
Tennessee Consolidated Retirement System

For the Year Ended
June 30, 2002

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
State Capitol
Nashville, Tennessee 37243-0260
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John G. Morgan
Comptroller

March 13, 2003

Members of the General Assembly
and
The Honorable Steve Adams, Treasurer
and
Members of the Board
Tennessee Consolidated Retirement System
State Capitol
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Consolidated Retirement System for the year ended June 30, 2002. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance disclosed a deficiency, which is detailed in the Results of the Audit section of this report. The Tennessee Consolidated Retirement System's management has responded to the audit finding; the response is included following the finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit finding.

Sincerely,

John G. Morgan

John G. Morgan
Comptroller of the Treasury

JGM/mb
02/099

State of Tennessee

Audit Highlights

Comptroller of the Treasury   Division of State Audit

Financial and Compliance Audit
Tennessee Consolidated Retirement System
For the Year Ended June 30, 2002

AUDIT OBJECTIVES

The objectives of the audit were to consider the Tennessee Consolidated Retirement System's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, and contracts; to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

INTERNAL CONTROL FINDING

The Tennessee Consolidated Retirement System (TCRS) Should Strengthen Controls for Preventing, Detecting, and Collecting Overpayments to Deceased Persons*
TCRS procedures do not require sufficient evidence to refute a death match. In addition, TCRS did not comply with written procedures regarding the approval of accounts receivable forms (page 9).

*This finding is repeated from the prior audit.

OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is unqualified.

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report which contains all findings, recommendations, and management comments, please contact

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Audit Report
Department of the Treasury
Tennessee Consolidated Retirement System
For the Year Ended June 30, 2002

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Department of the Treasury
Tennessee Consolidated Retirement System
For the Year Ended June 30, 2002

INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Tennessee Consolidated Retirement System. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to "perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller."

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

The Tennessee Consolidated Retirement System (TCRS) was established in 1972 by an act of the Tennessee General Assembly. Seven existing retirement systems were consolidated to provide retirement, disability, and death benefits to state employees, public school teachers, higher education employees, and employees of participating local governments. State laws govern the retirement plan, and amendments to the plan can only be made by legislation enacted by the General Assembly of the State of Tennessee.

An 18-member board of trustees has the responsibility to manage and oversee the operation of the consolidated system. The board consists of nine *ex officio* members from the executive, legislative, and judicial branches of state government; eight representatives of the active TCRS membership; and one representative of retirees. TCRS is administered by the Department of the Treasury under the legislative branch of state government. By state law, the State Treasurer serves as chairman of the board of trustees and as custodian of the funds of the system.

Membership in the retirement system is a condition of employment for full-time state employees, K-12 teachers, higher education general employees, and employees of participating local governments. Membership is optional for part-time state employees and part-time employees of political subdivisions which have authorized such coverage. Interim teachers and part-time teachers have optional membership. Faculty and certain other employees of institutions of higher education may elect participation in either TCRS or an optional retirement program. TCRS membership has grown steadily since 1972, when there were approximately 93,000 members. As of June 30, 2002, there were 197,971 active members and 80,426 retirees.

ORGANIZATION

The Tennessee Consolidated Retirement System is organized into three major service areas: Counseling Services, Member Services, and Financial Services.

Counseling Services is responsible for preretirement counseling of members on their potential benefit payments under different options. The section processes claims for disability retirement and provides field support, including new employer coverage. The section also processes membership forms received from all state agencies, local boards of education, and participating political subdivisions.

Member Services is responsible for prior-service and benefit calculations. Prior-service specialists assist in establishing prior-service credit for eligible members or former members who have requested such credit. Benefit calculation specialists compute new retiree benefits based on the option chosen.

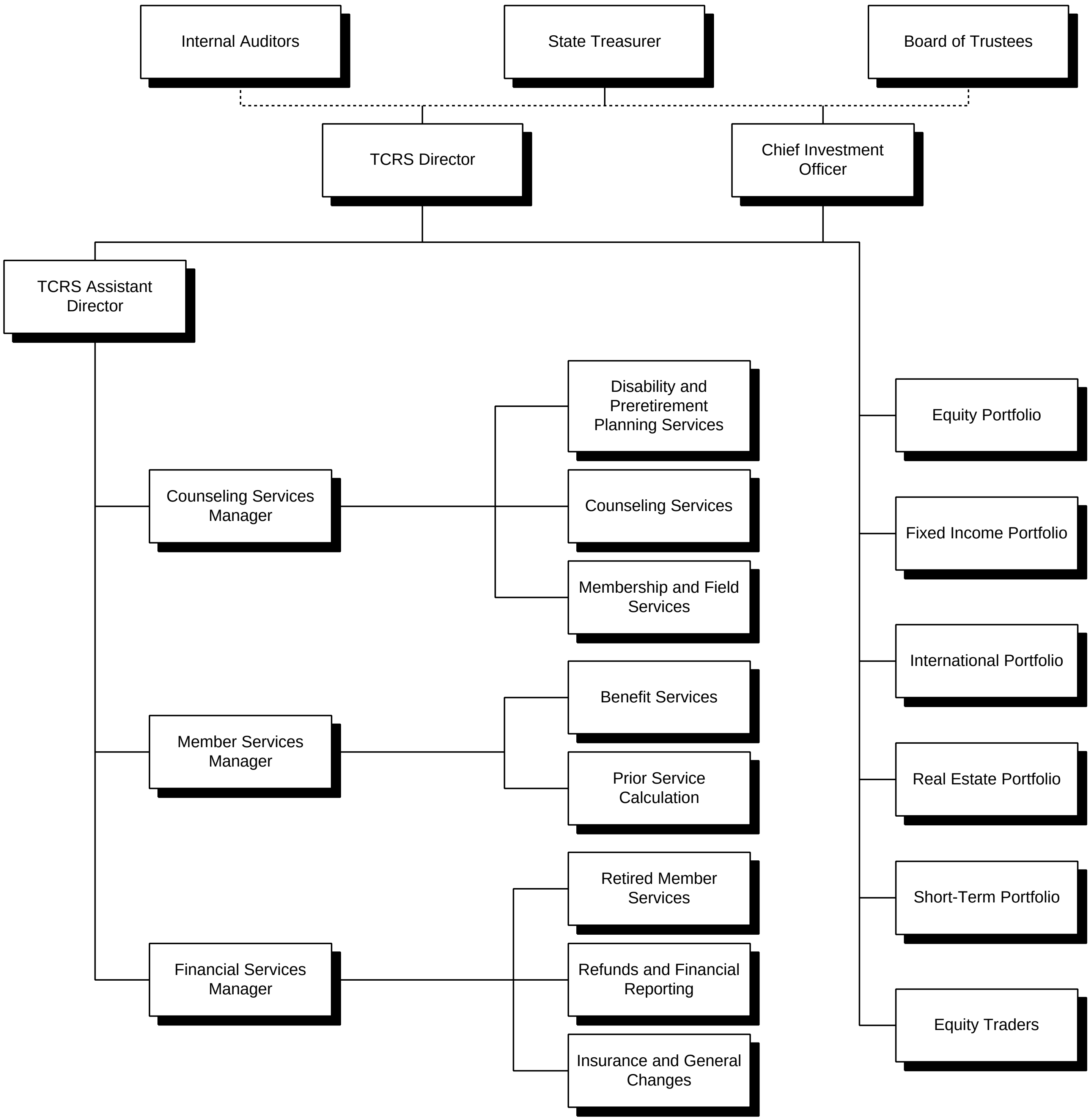
Financial Services processes refunds to terminated members, administers the retired payroll, distributes the pension payments, administers retiree insurance, and coordinates actuarial valuations. The section is also responsible for researching, controlling, and correcting member records on the Treasury Retirement Accounting and Control System.

An organization chart for the Tennessee Consolidated Retirement System is on the following page.

AUDIT SCOPE

The audit was limited to the period July 1, 2001, through June 30, 2002, and was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Financial statements are presented for the year ended June 30, 2002. The Tennessee Consolidated Retirement System forms an integral part of state government and as such has been included as pension trust funds in the *Tennessee Comprehensive Annual Financial Report*.

Tennessee Consolidated Retirement System
Organization Chart



OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the Tennessee Consolidated Retirement System's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;

2. to determine compliance with certain provisions of laws, regulations, and contracts;

3. to determine the fairness of the presentation of the financial statements; and

4. to recommend appropriate actions to correct any deficiencies.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Tennessee Consolidated Retirement System filed its report with the Department of Audit on June 24, 2002. A follow-up of all prior audit findings was conducted as part of the current audit.

RESOLVED AUDIT FINDING

The current audit disclosed that the Tennessee Consolidated Retirement System has corrected the previous audit finding concerning the development and implementation of written procedures related to the preparation and use of credit analysis reports that support the purchase of commercial paper.

REPEATED AUDIT FINDING

The prior audit report also contained a finding concerning controls for preventing, detecting, and collecting overpayments to deceased persons. This finding has not been completely resolved and is repeated in this report.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the Tennessee Consolidated Retirement System's financial statements for the year ended June 30, 2002, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. A reportable condition, along with the recommendation and management's response, is detailed in the finding and recommendation. Consideration of internal control over financial reporting disclosed no material weaknesses.

Compliance

The results of our audit tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Fairness of Financial Statement Presentation

The Division of State Audit has rendered an unqualified opinion on the Tennessee Consolidated Retirement System's financial statements.

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Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

December 11, 2002

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the financial statements of the Tennessee Consolidated Retirement System as of and for the year ended June 30, 2002, and have issued our report thereon dated December 11, 2002. As discussed in Note A.6. to the financial statements, the Tennessee Consolidated Retirement System implemented Governmental Accounting Standards Board Statement 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments.* The Tennessee Consolidated Retirement System also implemented GASB Statement 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*, and GASB Statement 38, *Certain Financial Statement Note Disclosures*. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Tennessee Consolidated Retirement System's financial statements are free of material misstatement, we performed tests of the system's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

We did, however, note a less significant instance of noncompliance, which we have reported to the system's management in a separate letter.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Tennessee Consolidated Retirement System's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the system's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

The following reportable condition was noted:

- The Tennessee Consolidated Retirement System should strengthen controls for preventing, detecting, and collecting overpayments to deceased persons.

This condition is described in the Finding and Recommendation section of this report.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we do not believe the reportable condition described above is a material weakness.

We also noted other matters involving the internal control over financial reporting, which we have reported to the system's management in a separate letter.

This report is intended solely for the information and use of the General Assembly of the State of Tennessee and management and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,

Arthur A. Hayes, Jr., CPA,
Director

AAH/mb

FINDING AND RECOMMENDATION

<u>The Tennessee Consolidated Retirement System should strengthen controls for preventing, detecting, and collecting overpayments to deceased persons</u>

Finding

The Tennessee Consolidated Retirement System receives death match reports from a contracted vendor twice each year. In addition, death match reports are generated quarterly using information obtained from the Department of Health. These death match reports serve as the primary basis for preventing, detecting, and collecting overpayments to deceased persons. Management has developed written procedures to be performed in regard to the information contained in these death match reports. Our prior-year audit reported several weaknesses regarding the written procedures over death match reports as well as instances of noncompliance with written procedures. Management concurred with the prior audit finding and indicated that new procedures would be developed and that staff would be trained to follow the new procedures.

During the current audit, we reviewed the new procedures for adequacy and tested a sample of retirees and beneficiaries that were reported as deceased in death match reports. Based on our review and testwork, it appears the design and operation of the new procedures were sufficient to ensure that member accounts were placed in pending status promptly and collection procedures were started in a timely manner. However, our review of the new procedures indicated that management still does not require sufficient evidence to refute a death match. In addition, discussions with management indicated that not all the revised procedures were being followed.

Management's primary control to determine if a retiree or beneficiary appearing on the death match reports is deceased is to send a letter to the retiree or beneficiary. The letter instructs the retiree or beneficiary to fill out the bottom portion of the letter and return the letter to TCRS. If the letter is returned to TCRS, management regards this as a sufficient basis to continue payments to the retiree or beneficiary. As noted in the prior audit, management has not obtained sufficient assurance that the letters are not completed and signed fraudulently by someone other than the retiree or beneficiary. Based on review, management did not address this prior-year audit recommendation in developing revised procedures.

Our prior-year audit finding also recommended that management ensure that written procedures address the various circumstances that arise as a result of overpayments and that employees comply with the procedures. Specifically, we recommended that the Director of TCRS should ensure that time requirements for sending letters, procedures for payments made by automated clearing house transfers, and any reviews and approvals of overpayment documentation be adequately addressed in the procedures. Based on review, it appears the revised procedures do address these specific recommendations. However, in regard to approvals required by the revised procedures, it does not appear that management has ensured that staff complied with the revised procedures. Based on discussions with management, the accounts receivable form is not approved by the Manager of Financial Services as required by the revised procedures.

If control procedures are not adequate to obtain a sufficient basis to continue payments to retirees and beneficiaries, the risk that overpayments will not be prevented and detected is increased. If accounts receivable forms are not reviewed and approved, the risk that accounts receivable will not be properly recorded is increased.

Recommendation

Written procedures should be strengthened to attain a higher level of assurance that information received in the letters returned by retirees and beneficiaries is complete, accurate, and sufficient to continue making payments to retirees and beneficiaries that have been reported as deceased. One way to strengthen procedures would be for the letters sent to the retirees and beneficiaries to contain language outlining the consequences of submitting inaccurate information and for the letters returned by the retirees and beneficiaries to be signed in the presence of a notary public. In addition, management should ensure that the Manager of Financial Services approves the accounts receivable form as required by written procedures.

Management's Comment

Management concurs. Management will take additional verification steps for those retirees reported as deceased, but notify TCRS that they are alive. Management will also review procedures and revise as appropriate to ensure that accounts receivable are being recorded.

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Independent Auditor's Report

December 11, 2002

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the accompanying statements of plan net assets of the Tennessee Consolidated Retirement System as of June 30, 2002, and June 30, 2001, and the related statements of changes in plan net assets for the years then ended. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements, based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note A.1., the financial statements referred to above present only the plan net assets and changes in plan net assets of the Pension Trust Funds of the State of Tennessee and are not intended to present fairly the financial position and changes in financial position of the State of Tennessee, in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the plan net assets of the Tennessee Consolidated Retirement System as of June 30, 2002, and June 30, 2001, and the changes in its plan net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note A.6. to the financial statements, the Tennessee Consolidated Retirement System implemented Governmental Accounting Standards Board Statement 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments.* The Tennessee Consolidated Retirement System also implemented GASB Statement 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*, and GASB Statement 38, *Certain Financial Statement Note Disclosures*.

The management's discussion and analysis section and the schedules of funding progress and employer contributions, as listed in the table of contents, are not required parts of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 11, 2002, on our consideration of the Tennessee Consolidated Retirement System's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Sincerely,

Arthur A. Hayes, Jr.

Arthur A. Hayes, Jr., CPA,
Director

AAH/mb

The Management of the Tennessee Consolidated Retirement System (TCRS) provides this discussion and analysis as an overview of the TCRS' financial activities for the fiscal year ended June 30, 2002.

FINANCIAL HIGHLIGHTS

- The plan net assets (total assets minus total liabilities) of the TCRS at June 30, 2002 were over $23.0 billion. This is a decrease of over $690 million (2.9 percent) from the plan net assets at June 30, 2001. The net assets are held in trust to meet future benefit obligations.

- The TCRS relies upon contributions from employees and employers, along with investment income, to meet the funding requirements of an actuarially determined accrued liability. As of July 1, 2001, the date of the latest actuarial valuation, the TCRS' funded ratio was 99.61 percent for the SETHEEPP group and 90.36 percent for the PSPP group.

- Total revenues for fiscal year 2002 were $157,281,294 (decrease of 16.7 percent compared to fiscal year 2001), which consisted of $536,137,611 in contributions (increase of 3.8 percent compared to fiscal year 2001) and $378,856,317 of net investment loss (increase of 15.7 percent compared to fiscal year 2001).

- Total expenses for fiscal year 2002 were $847,399,657 – an increase of 7.5 percent over fiscal year 2001 total expenses.

OVERVIEW OF THE FINANCIAL STATEMENTS

The TCRS financial statements consist of the *Statement of Plan Net Assets (*on pages 22 through 23), the *Statement of Changes in Plan Net Assets* (on pages 24 through 25), and the *Notes to the Financial Statements* (on pages 26 through 31). In addition, *Required Supplementary Information* is presented, which includes this *Management Discussion and Analysis,* as well as the schedules and notes on pages 32 through 33.

The *Statement of Plan Net Assets* and the *Statement of Changes in Plan Net Assets* report information about the plan net assets as of the end of the fiscal year and the changes in those plan net assets during the fiscal year. These statements include all assets and liabilities using the accrual basis of accounting. Under the accrual basis of accounting, the current year's revenues and expenses are included in the financial activity, regardless of when cash is received or paid. The difference between the total assets and total liabilities on the *Statement of Plan Net Assets*, or net assets held in trust for pension benefits, provides a measurement of the financial position of the TCRS as of the end of the fiscal year. The *Statement of Changes in Plan Net Assets* provides information on the activities that caused the financial position to change during the fiscal year. Over time, increases or decreases in the plan net assets of the TCRS are one indicator of whether the system's financial health is improving or deteriorating.

In addition to the two basic financial statements, the reader should also review the *Schedules of Funding Progress*, the *Schedules of Employer Contributions* and the accompanying *Notes to Required Supplementary Information* to gain an understanding of the funded status of the TCRS over time. This information provides an indication of the TCRS' ability to meet both current and future benefit payment obligations. The *Notes to the Financial Statements* are also important to the reader's understanding of the financial statements and provide additional information regarding the TCRS, such as descriptions of the plans administered by the TCRS, including contribution and benefit provisions, and information about the accounting policies and investment activities.

ANALYSIS OF ASSETS, LIABILITIES AND PLAN NET ASSETS

At June 30, 2002, the TCRS had plan net assets of over $23.0 billion, down over $690 million (2.9 percent) from $23.7 billion as of June 30, 2001. The assets of the TCRS consist primarily of cash and investments. The decrease in plan net assets, as seen over the past two fiscal years, is the result of net negative investment income due primarily to the depreciation in the fair value of investments, caused by unfavorable equity market conditions. Condensed financial information comparing the TCRS' plan net assets for the past two fiscal years is presented on the following page.

(continued)

PLAN NET ASSETS AT JUNE 30, 2002 AND JUNE 30, 2001

	June 30, 2002	June 30, 2001	Percentage Change
ASSETS			
Cash and cash equivalents	$ 1,621,359,545	$ 779,786,367	107.9 %
Contributions receivables	46,238,224	44,992,609	2.8 %
Investment income receivables	147,069,784	189,993,764	(22.6)%
Investments sold	17,336,115	269,774,623	(93.6)%
Short-term securities	317,388,429	519,748,610	(38.9)%
Long-term investments	21,015,023,754	22,599,841,303	(7.0)%
Invested securities lending collateral	0	113,685,867	(100.0)%
TOTAL ASSETS	23,164,415,851	24,517,823,143	(5.5)%
LIABILITIES			
Death benefits, refunds and other payables	1,141,905	1,014,443	12.6 %
Investments purchased	112,553,617	662,796,260	(83.0)%
Other investment payables	2,633,994	2,121,875	24.1 %
Securities lending collateral	0	113,685,867	(100.0)%
TOTAL LIABILITIES	116,329,516	779,618,445	(85.1)%
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS	$ 23,048,086,335	$ 23,738,204,698	(2.9)%

ANALYSIS OF REVENUES AND EXPENSES

While contributions to TCRS for fiscal year 2002 increased by $19.7 million (3.8 percent) over contributions for fiscal year 2001, net investment income for fiscal year 2002 decreased by more than $51.3 million (15.7 percent) compared to fiscal year 2001. Overall, revenues for fiscal year 2002 declined 16.7 percent compared to revenues for fiscal year 2001. Although employer contribution rates did not change during fiscal year 2002, the increase in contributions can be attributed to new employers joining TCRS and increased salaries. Market conditions resulted in reduced investment income with an overall loss to the TCRS investment portfolio of 1.9 percent.

In addition, total expenses, including benefits and administrative expenses for fiscal year 2002 increased by 7.5 percent over fiscal year 2001. The increase in benefit expenses can be attributed to a 3 percent cost of living adjustment awarded to retirees on July 1, 2001 in addition to more retirees being added to payroll than removed during the fiscal year. Administrative expenses were more consistent than would appear. A one-time refund of $1.14 million related to several years of office space overbilling charges was returned to TCRS in fiscal year 2001, thus reducing the total administrative cost. Additionally during fiscal year 2002, a biennial actuarial study was performed increasing actuarial consulting costs.

Condensed financial information comparing the TCRS' revenues and expenses for the past two fiscal years follows.

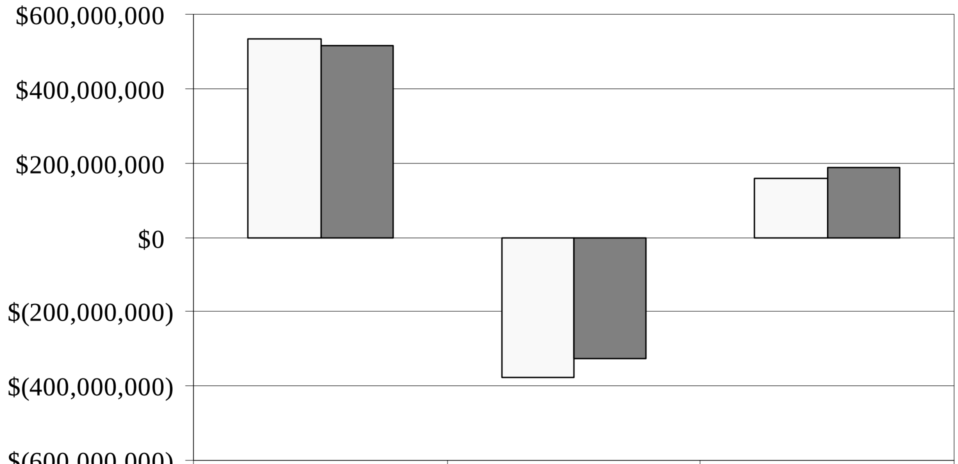
(continued)

STATEMENT OF CHANGES IN PLAN NET ASSETS

	For the Year Ended June 30, 2002	For the Year Ended June 30, 2001	Percentage Change
ADDITIONS			
Contributions	$ 536,137,611	$ 516,416,729	3.8 %
Investment income			
Net depreciation in fair value of investments	(1,290,032,957)	(1,382,747,281)	(6.7)%
Interest, dividends and other investment income	924,647,372	1,066,991,030	(13.3)%
Less: Investment expense	(14,093,999)	(12,375,102)	13.9%
Net income from securities lending activities	623,267	619,652	0.6 %
Net investment loss	(378,856,317)	(327,511,701)	15.7%
TOTAL ADDITIONS	157,281,294	188,905,028	(16.7)%
DEDUCTIONS			
Annuity benefits			
Retirement benefits	610,554,871	566,721,390	7.7 %
Survivor benefits	38,723,935	36,024,095	7.5 %
Disability benefits	20,109,341	18,567,921	8.3 %
Cost of living	145,335,114	130,369,319	11.5 %
Death benefits	3,367,876	4,701,538	(28.4)%
Refunds	24,304,536	28,517,803	(14.8)%
Administrative expenses	5,003,984	3,477,600	43.9 %
TOTAL DEDUCTIONS	847,399,657	788,379,666	7.5 %
NET DECREASE	(690,118,363)	(599,474,638)	15.1%
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS			
BEGINNING OF YEAR	23,738,204,698	24,337,679,336	(2.5)%
END OF YEAR	$ 23,048,086,335	$ 23,738,204,698	(2.9)%

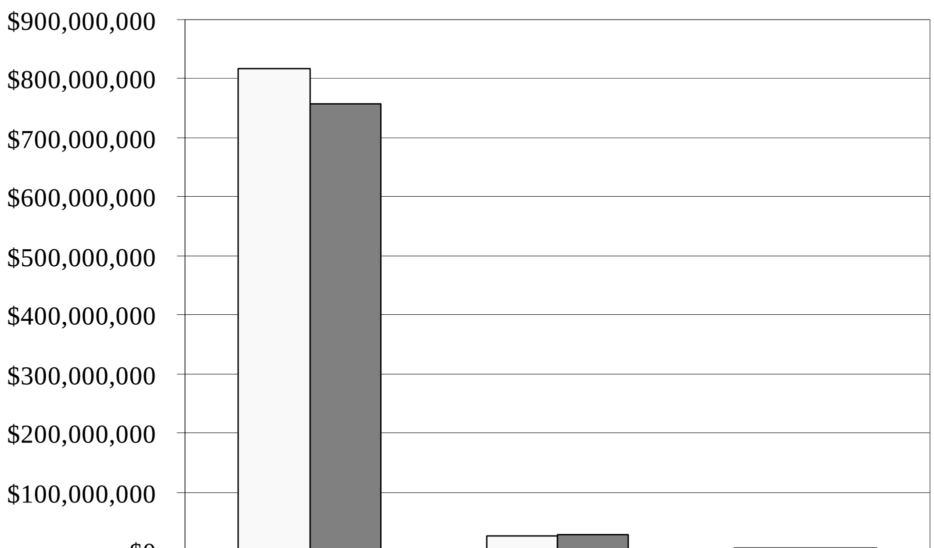
(continued)

REVENUES BY TYPE FOR THE YEARS ENDED JUNE 30, 2002 AND JUNE 30, 2001



	Contributions	Net Investment Income (Loss)	Total Additions
☐ Year Ended 6/30/02	$536,137,611	$(378,856,317)	$157,281,294
■ Year Ended 6/30/01	$516,416,729	$(327,511,701)	$188,905,028

EXPENSES BY TYPE FOR THE YEARS ENDED JUNE 30, 2002 AND JUNE 30, 2001



	Benefit Payments	Refunds	Administrative
☐ Year Ended 6/30/02	$818,091,137	$24,304,536	$5,003,984
■ Year Ended 6/30/01	$756,384,263	$28,517,803	$3,477,600

(continued)

ECONOMIC FACTORS, FUTURE FUNDING PROVISIONS, OVERALL OUTLOOK

The past two years have been difficult for both the domestic and international stock markets. The S & P 500, TCRS's domestic equity benchmark, was down 14.83 percent at June 30, 2001 and 17.99 percent at June 30, 2002. The NASDAQ, an index that includes the hard hit technology sector, small cap stocks, and dot.com companies, was down 45.37 percent and 32.05 percent during the same period. The international markets, as measured by the EAFE index, did not fair any better being down 23.83 percent and 9.49 percent. Fortunately, the domestic bond market performed better with positive results of 11.22 percent and 8.63 percent.

The last two years proved the benefits of having a diversified portfolio. Despite large negative stock returns, the TCRS portfolio had losses of only 1.57 percent at June 30, 2001 and 1.92 percent at June 30, 2002. TCRS was ranked near the top in investment performance of public pension plans during this period.

The first quarter of the 2002-03 fiscal year was even more difficult with the domestic stock market down 17.28 percent (nearly the same as the previous 12 months) and the international market down 19.73 percent. Again, the bond market had positive returns of 4.58 percent.

While the TCRS has had excellent performance on a relative basis, it must be recognized that the losses during the last two years as compared to the 7.5 percent actuarial earnings assumption will put upward pressure on the employer contribution rate at the next actuarial valuation set for July 1, 2003, as well as subsequent valuations.

CONTACTING THE TCRS

This report is designed to provide a financial overview of the TCRS to state legislators, members of the Board of Trustees of the TCRS, state officials, participating employers and any other interested parties. Questions or requests for additional information regarding the financial information presented in this report may be addressed in writing to the Tennessee Treasury Department, Consolidated Retirement System, 10th Floor Andrew Jackson Building, Nashville, Tennessee 37243-0230.

Expressed in Thousands	**State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)**	**Political Subdivisions Pension Plan (PSPP)**
ASSETS		
Cash and cash equivalents	$ 1,400,985	$ 220,375
Receivables		
Member contributions receivable	15,250	4,050
Employer contributions receivable	18,191	8,747
Accrued interest receivable	116,555	18,334
Accrued dividends receivable	10,524	1,656
Other investment receivable	1	0
Investments sold	14,980	2,356
Total receivables	175,501	35,143
Investments, at fair value		
Short-term securities	274,249	43,139
Government bonds	7,517,687	1,182,530
Corporate bonds	2,404,488	378,226
Corporate stocks	7,931,835	1,247,676
Real estate	304,659	47,923
Invested securities lending collateral	0	0
Total investments	18,432,918	2,899,494
TOTAL ASSETS	20,009,404	3,155,012
LIABILITIES		
Accounts payable		
Death benefits and refunds payable	461	645
Other	36	0
Investments purchased	97,256	15,298
Other investment payables	2,276	358
Securities lending collateral	0	0
TOTAL LIABILITIES	100,029	16,301
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS (Schedules of funding progress for the plans are presented on page 32)	$ 19,909,375	$ 3,138,711

See accompanying Notes to the Financial Statements

(continued)

(CONTINUED)

June 30, 2002 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	June 30, 2001 Total
$ 1,621,360	$ 676,173	$ 103,613	$ 779,786
19,300	15,055	3,809	18,864
26,938	17,681	8,447	26,128
134,889	160,809	24,641	185,450
12,180	3,840	588	4,428
1	101	15	116
17,336	233,929	35,846	269,775
210,644	431,415	73,346	504,761
317,388	450,688	69,061	519,749
8,700,217	7,795,671	1,194,563	8,990,234
2,782,714	3,100,092	475,040	3,575,132
9,179,511	8,449,363	1,294,730	9,744,093
352,582	251,798	38,584	290,382
0	98,580	15,106	113,686
21,332,412	20,146,192	3,087,084	23,233,276
23,164,416	21,253,780	3,264,043	24,517,823
1,106	644	359	1,003
36	11	0	11
112,554	574,728	88,068	662,796
2,634	1,840	282	2,122
0	98,580	15,106	113,686
116,330	675,803	103,815	779,618
$ 23,048,086	$ 20,577,977	$ 3,160,228	$ 23,738,205

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
COMPARATIVE STATEMENTS OF CHANGES IN PLAN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2002 AND JUNE 30, 2001

Expressed in Thousands	**State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)**	**Political Subdivisions Pension Plan (PSPP)**
ADDITIONS		
Contributions		
Member contributions	$ 142,126	$ 47,139
Employer contributions	243,498	103,374
Total contributions	385,624	150,513
Investment income		
Net depreciation in fair value of investments	(1,114,237)	(175,796)
Interest	642,392	101,391
Dividends	132,758	20,953
Real estate income, net of operating expenses	23,452	3,701
Total investment loss	(315,635)	(49,751)
Less: Investment expense	(12,190)	(1,904)
Net loss from investing activities	(327,825)	(51,655)
Securities lending activities		
Securities lending income	1,492	235
Less: securities lending expense	(953)	(150)
Net income from securities lending activities	539	85
Net investment loss	(327,286)	(51,570)
Transfer of assets from PSPP	0	0
TOTAL ADDITIONS	58,338	98,943
DEDUCTIONS		
Annuity benefits		
Retirement benefits	528,471	82,084
Survivor benefits	33,518	5,206
Disability benefits	17,405	2,704
Cost of living	129,918	15,417
Death benefits	2,225	1,143
Refunds	12,689	11,616
Administrative expense	2,714	2,290
Transfer of assets to SETHEEPP	0	0
TOTAL DEDUCTIONS	726,940	120,460
NET DECREASE	(668,602)	(21,517)
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS		
BEGINNING OF YEAR	20,577,977	3,160,228
END OF YEAR	$ 19,909,375	$ 3,138,711

See accompanying Notes to the Financial Statements

(continued)

June 30, 2002 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	June 30, 2001 Total
$ 189,265	$ 135,154	$ 45,433	$ 180,587
346,872	232,149	103,681	335,830
536,137	367,303	149,114	516,417
(1,290,033)	(1,198,688)	(184,059)	(1,382,747)
743,783	806,941	123,906	930,847
153,711	101,496	15,585	117,081
27,153	16,525	2,538	19,063
(365,386)	(273,726)	(42,030)	(315,756)
(14,094)	(10,738)	(1,637)	(12,375)
(379,480)	(284,464)	(43,667)	(328,131)
1,727	2,078	319	2,397
(1,103)	(1,540)	(237)	(1,777)
624	538	82	620
(378,856)	(283,926)	(43,585)	(327,511)
0	12,604	0	12,604
157,281	95,981	105,529	201,510
610,555	491,204	75,517	566,721
38,724	31,224	4,800	36,024
20,109	16,094	2,474	18,568
145,335	116,892	13,477	130,369
3,368	3,720	982	4,702
24,305	16,484	12,034	28,518
5,004	1,795	1,683	3,478
0	0	12,604	12,604
847,400	677,413	123,571	800,984
(690,119)	(581,432)	(18,042)	(599,474)
23,738,205	21,159,409	3,178,270	24,337,679
$ 23,048,086	$ 20,577,977	$ 3,160,228	$ 23,738,205

The Tennessee Consolidated Retirement System (TCRS) administers two defined benefit pension plans - State Employees, Teachers and Higher Education Employees Pension Plan (SETHEEPP) and Political Subdivisions Pension Plan (PSPP). Although the assets of the plans are commingled for investment purposes, each plan's assets may be used only for the payment of benefits to members of that plan, in accordance with the terms of the plan.

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. **Reporting Entity** - The TCRS is included in the State of Tennessee Financial Reporting Entity. Because of the state's fiduciary responsibility, the TCRS has been included as pension trust funds in the *Tennessee Comprehensive Annual Financial Report*.

2. **Measurement Focus and Basis of Accounting** - The accompanying financial statements have been prepared in conformity with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB). The TCRS follows all applicable GASB pronouncements, as well as applicable private sector pronouncements issued on or before November 30, 1989. The financial statements have been prepared using the flow of economic resources measurement focus and the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

   Plan member contributions are recognized in the period in which the contributions are due. Plan employer contributions are recognized when due and the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of each plan.

3. **Cash and Cash Equivalents** - Cash and cash equivalents, by definition, includes cash and short-term investments with a maturity date within three months of the acquisition date. The state's accounting policy regarding the definition of cash and cash equivalents includes cash management pools as cash. Cash received by the TCRS that cannot be invested immediately in securities is invested in the State Pooled Investment Fund administered by the State Treasurer. The State Pooled Investment Fund is authorized by state statute to invest funds in accordance with policy guidelines approved by the Funding Board of the State of Tennessee. The current resolution of that board gives the Treasurer authority to invest in collateralized certificates of deposit in authorized state depositories, prime commercial paper, prime bankers' acceptances, certain repurchase agreements, various U.S. Treasury and Agency obligations, and in obligations of the state of Tennessee pursuant to *Tennessee Code Annotated*, Section 9-4-602(b). The State Pooled Investment Fund is also authorized to enter into securities lending agreements in which U.S. Government Securities may be loaned for a fee. The loaned securities are transferred to the borrower by the custodial agent upon simultaneous receipt of collateral securities. The pool's custodial credit risk is presented in the *Tennessee Comprehensive Annual Financial Report* for the years ended June 30, 2002 and June 30, 2001. The classification of cash and cash equivalents also includes cash held in a custody account under a contractual arrangement for master custody services. Cash balances with the custodial agent are not classified into the credit risk categories established by Statement Number 3 of the Governmental Accounting Standards Board as the custody account relationship does not meet the definition for either a deposit with a financial institution or a security.

4. **Method Used to Value Investments** - Investments are reported at fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Short-term investments that do not have an established market are reported at cost plus accrued interest which approximates fair value. The fair value of real estate investments is determined at least every three years by qualified independent appraisers who are members of the Appraisal Institute and internally by real estate advisors for those years when independent appraisals are not performed. Investment income consists of realized and unrealized appreciation (depreciation) in the fair value of investments. Interest income is recognized when earned. Securities and securities transactions are recorded in the financial statements on trade-date basis.

5. **Receivables** - Receivables primarily consist of interest which is recorded when earned. The receivables for contributions as of June 30, 2002 consist of member contributions of $15.3 million and $4.0 million due to SETHEEPP and PSPP respectively, and employer contributions of $18.2 million and $8.7 million due to SETHEEPP and PSPP respectively. The receivables for contributions as of June 30, 2001 consist of member contributions of $15.1 million and $3.8 million due to SETHEEPP and PSPP respectively, and employer contributions of $17.7 million and $8.4 million due to SETHEEPP and PSPP respectively.

(continued)

6. **Adoption of New Accounting Pronouncements** - Effective July 1, 2001, the TCRS, along with the State of Tennessee, adopted the provisions of Statement No. 34 of the Governmental Accounting Standards Board, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments* and its related *Omnibus* Statement No. 37. Accordingly, a management's discussion and analysis (MD&A) has been included in the presentation of required supplementary information (RSI). The TCRS has also adopted the provisions of Statement No. 38, *Certain Financial Statement Note Disclosures* and has included applicable disclosures in the Notes to the Financial Statements.

B. PLAN DESCRIPTIONS AND CONTRIBUTION INFORMATION

At July 1, 2001, the date of the latest actuarial valuation, the membership of each plan consisted of the following:

	SETHEEPP	PSPP
Retirees and beneficiaries currently receiving benefits	56,444	21,298
Terminated members entitled to but not receiving benefits	15,895	3,500
Current active members	126,069	68,656
Total	198,408	93,454
Number of participating employers	140	404

State Employees, Teachers and Higher Education Employees Pension Plan

Plan Description - SETHEEPP is a cost-sharing, multiple employer defined benefit pension plan that covers the employees of the state, teachers with Local Education Agencies (LEA's) and higher education employees. The TCRS provides retirement benefits as well as death and disability benefits to plan members and their beneficiaries. Benefits are determined by a formula using the member's high five-year average salary and years of service. Members become eligible to retire at the age of 60 with five years of service or at any age with 30 years of service. A reduced retirement benefit is available to vested members who are at least 55 years of age or have 25 years of service. Disability benefits are available to active members with five years of service who become disabled and cannot engage in gainful employment. There is no service requirement for disability that is the result of an accident or injury occurring while the member was in the performance of duty. Members joining the plan on or after July 1, 1979 are vested after five years of service. Members joining prior to July 1, 1979 are vested after four years of service. Compounded cost of living adjustments (COLA) are provided each July based on the percentage change in the Consumer Price Index (CPI) during the previous calendar year except that (a) no COLA is granted if the CPI is less than one-half percent; (b) a COLA of 1 percent will be granted if the CPI increases between one-half percent and one percent; (c) the maximum annual COLA is capped at three percent. Benefit provisions are established by state statute found in Title Eight, Chapters 34 through 37 of the *Tennessee Code Annotated*. State statutes are amended by the Tennessee General Assembly. Ad hoc increases may only be authorized by the General Assembly. Public safety officers receive an additional supplemental benefit that is paid from age 60 to age 62.

Superseded Systems and Certain Employment Classifications - Members of superseded systems that became members of the TCRS at consolidation in 1972, have their rights preserved to the benefits of the superseded system, if the benefit from the superseded plan exceeds that provided by the Group 1 (teachers and general employees) TCRS formula. Likewise, public safety employees and officials of TCRS Groups 2, 3 and 4 are entitled to the benefits of those formulas, if better than the Group 1 benefits.

Contributions and Reserves - Effective July 1, 1981, the plan became noncontributory for most state and higher education employees. The contribution rate for teachers is five percent of gross salary. The employers contribute a set percentage of their payrolls, determined by an actuarial valuation. *Tennessee Code Annotated* Title Eight, Chapter 37 provides that the contribution rates be established and may be amended by the Board of Trustees of the TCRS. The administrative budget for the plan is approved through the state of Tennessee's annual budget process. Funding for the administrative budget is included in employer contributions.

The net assets of the plan are legally required to be reserved in two accounts, the Member Reserve and the Employer Reserve. The Member Reserve represents the accumulation of employee contributions plus interest. The Employer Reserve represents the accumulation of employer contributions, investment income and transfers from the Member Reserve for retiring members. Benefit payments and interest credited to the members' accounts are reductions to the Employer Reserve. At June 30, 2002, the plan's Member Reserve and Employer Reserve

(continued)

were fully funded with balances of $2,781.9 million and $17,127.5 million, respectively. At June 30, 2001, the plan's Member Reserve and Employer Reserve were fully funded with balances of $2,640.7 million and $17,937.3 million, respectively.

Political Subdivisions Pension Plan

Plan Description - PSPP is an agent multiple-employer defined benefit pension plan that covers the employees of participating political subdivisions of the state of Tennessee. Employee class differentiations are not made under PSPP. The TCRS provides retirement benefits as well as death and disability benefits to plan members and their beneficiaries. Benefits are determined by a formula using the member's high five-year average salary and years of service. Members become eligible to retire at the age of 60 with five years of service or at any age with 30 years of service. A reduced retirement benefit is available to vested members who are at least 55 years of age or have 25 years of service. Disability benefits are available to active members with five years of service who become disabled and cannot engage in gainful employment. There is no service requirement for disability that is the result of an accident or injury occurring while the member was in the performance of duty. Members joining the plan prior to July 1, 1979 are vested after four years of service. Members joining on or after July 1, 1979 are vested upon completion of 10 years of service, unless five years vesting is authorized by resolution of the chief governing body. Cost of living adjustments (COLA) are the same as provided by SETHEEPP except that the local government may elect (a) to provide no COLA benefits or (b) to provide COLA benefits under a non-compounding basis rather than the compounded basis applicable under SETHEEPP. Benefit provisions are established and amended by state statute. Pursuant to Article Two, Section 24 of the *Constitution of the State of Tennessee*, the state cannot mandate costs on local governments. Any benefit improvement may be adopted by the governing body of a governmental entity participating in the TCRS.

Contributions and Reserves - Political subdivisions may elect contributory or noncontributory retirement for their employees. The contribution rate for contributory employees of political subdivisions is five percent of gross salary. The employers contribute a set percentage of their payrolls, equal to at least, the percentage determined by an actuarial valuation. State statute provides that the contribution rates be established and may be amended by the Board of Trustees of the TCRS. The administrative budget for the plan is approved through the state's annual budget process. Funding for the administrative budget is included in employer contributions.

The net assets of the plan are legally required to be reserved in two accounts, the Member Reserve and the Employer Reserve. The Member Reserve represents the accumulation of employee contributions plus interest. The Employer Reserve represents the accumulation of employer contributions, investment income and transfers from the Member Reserve for retiring members. Benefit payments and interest credited to the members' accounts are reductions to the Employer Reserve.

At June 30, 2002, the plan's Member Reserve and Employer Reserve were fully funded with balances of $643.7 million and $2,495.0 million, respectively. At June 30, 2001, the plan's Member Reserve and Employer Reserve were fully funded with balances of $592.3 million and $2,567.9 million respectively.

C. PLAN TRANSFERS

During Fiscal Year 2001, assets in the amount of $12.6 million, relating to the Regional Library System, were transferred from the PSPP to the SETHEEPP. Under *Tennessee Code Annotated*, Section 10, Chapter 5, Part 2, the employees of the Regional Library System, whose retirement assets were included in the PSPP, became employees of the Department of State, which is under the SETHEEPP plan.

D. INVESTMENTS

State statute authorizes the TCRS to invest in bonds, debentures, preferred stock and common stock, real estate and in other good and solvent securities subject to the approval of the Board of Trustees and further subject to the following restrictions:

a. The total sum invested in common and preferred stocks shall not exceed seventy-five percent (75 percent) of the total of the funds of the retirement system.

b. The total sum invested in notes and bonds or other fixed income securities exceeding one year in maturity shall not exceed seventy-five percent (75 percent) of the total funds of the retirement system. Private Placements are limited to 15 percent of the total fixed income portfolio.

(continued)

c. Within the restrictions in (a) and (b) above, an amount not to exceed fifteen percent (15 percent) of the total of the funds of the retirement system may be invested in securities of the same kinds, classes, and investment grades as those otherwise eligible for investment in various approved foreign countries.

d. The total amount of securities loaned under a securities lending program cannot exceed thirty percent (30 percent) of total assets.

e. The total sum invested in real estate shall not exceed five percent (5 percent) of the total of the funds of the retirement system.

The TCRS investment securities are categorized on the chart that follows according to the level of custodial credit risk associated with the custodial arrangements. Category 1 includes investments that are insured or registered, or for which the securities are held by the TCRS or its agent in the name of the TCRS. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the name of the TCRS. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by the counterparty's trust department or agent, but not in the name of the TCRS.

Expressed in Thousands	**Fair Value June 30, 2002**	**Fair Value June 30, 2001**
Investments - Category 1		
Cash equivalents and short-term securities		
Commercial paper	$ 762,737	$ 751,889
Corporate notes	90,489	15,320
Government bonds	1,089,855	533,584
Long-term investments		
Government bonds	8,588,873	8,872,472
Corporate bonds	2,782,714	3,575,132
Corporate stocks	9,167,281	9,102,052
Total Investments - Category 1	22,481,949	22,850,449
Investments - Category 2	0	0
Investments - Category 3		
Short-term securities lending collateral investments held by custodian bank		
Government bonds	0	63,135
Tri-party repurchase agreements	0	50,551
Margin deposit on futures contracts		
Government bonds	9,438	0
Total Investments - Category 3	9,438	113,686
Investments - Not Categorized		
Investments held by broker-dealers under securities on loan contracts for cash collateral		
Corporate stocks	0	97,563
Real estate	352,582	290,382
Unsettled investment acquisitions		
Government bonds	101,906	117,762
Corporate stocks	12,230	544,478
Total Investments - Not Categorized	466,718	1,050,185
Total investments and invested securities lending collateral	22,958,105	24,014,320
Less: Short-term securities classified as cash equivalents on the Statements of Plan Net Assets	(1,625,693)	(781,044)
Total investments and invested securities lending collateral as shown on the Statements of Plan Net Assets	$ 21,332,412	$ 23,233,276

(continued)

As of June 30, 2002 and June 30, 2001, the TCRS had no concentrations of investments, other than those issued or guaranteed by the U.S. government, in any one organization that represents five percent or more of plan net assets.

Securities Lending - The TCRS is authorized by its investment policy, as adopted by the Board of Trustees, to enter into collateralized securities lending agreements whereby the TCRS loans its debt and equity securities for a fee to a select few of the highest quality securities firms and banks. Loans must be limited so the total amount on loan does not exceed 30 percent of the TCRS' assets. The TCRS' custodian bank manages the lending program and maintains the collateral on behalf of the TCRS. The borrower must deliver cash collateral to the lending agent. The cash collateral may be reinvested by the lending agent in accordance with the investment policy, as further restricted under the TCRS securities lending agreement. Collateral securities cannot be pledged or sold unless the borrower defaults.

The loaned securities are initially collateralized at 102 percent of their fair value for domestic securities and 105 percent for international. Collateral is marked-to-market daily and additional collateral is pledged by the borrower if the fair value of the collateral subsequently falls below 100 percent for domestic securities and 105 percent for international. Although there is no specific policy for matching the maturities of collateral investments and the securities loans, the securities on loan can be terminated on demand by either the TCRS or the borrower. As of June 30, 2002, there were no securities on loan. The TCRS securities lending income, net of expenses, for the year ended June 30, 2002 was $623,267. As of June 30, 2001, the fair value of securities on loan to brokers was $97,563,290 and the fair value of collateral pledged for the securities on loan was $113,685,867. At June 30, 2001, the TCRS had no credit risk exposure to borrowers as the amounts owed to borrowers exceeded the amounts the borrowers owed the TCRS.

Financial Instruments with Off-Balance Sheet Risk - The TCRS is a party to financial instruments with off-balance sheet risk used in the normal course of business to generate earnings and reduce its own exposure to fluctuations in market conditions. The TCRS is authorized by statute to engage in forward contracts to exchange different currencies at a specified future date and rate and in domestic stock index futures contracts. These contracts involve elements of custodial credit, market and legal risk in excess of amounts recognized in the Statement of Plan Net Assets as of June 30, 2002 and June 30, 2001. The TCRS may purchase or sell domestic stock index futures contracts for the purposes of making asset allocation changes and improving liquidity. Futures contracts are limited to the S&P 500 Index, the S&P Midcap 400 Index and the Russell 2000 Index. The contractual or notional amounts express the extent of the TCRS' involvement in these instruments and do not represent exposure to credit loss. The credit risk on forward and futures contracts is controlled through limits and monitoring procedures. Market risk, the risk that changing market conditions may make a financial instrument less valuable, is controlled through limitations on the use of such instruments. Legal risk is controlled through the use of only authorized instruments and brokers. The allowable currencies for hedging purposes are limited by policy of the Board of Trustees to the currencies of those countries otherwise authorized for investment.

At June 30, 2002, there were forward exchange contracts outstanding at a total net notional amount of $896,129,128 and a fair value of $961,336,292. At June 30, 2001, there were forward exchange contracts outstanding at a total net notional amount of $17,113,000 and a fair value of $17,392,319.

At June 30, 2002, the notional amount of futures contracts was $128,868,750 at a fair value of $123,762,500. At June 30, 2001, the TCRS was not under any futures contracts.The changes in fair value of outstanding futures contracts are settled daily.

The TCRS is also authorized by investment policy to engage in the issuance of options. Activity is limited to selling covered call options. The TCRS had no options outstanding at June 30, 2002 and June 30, 2001.

Asset-Backed Securities - The TCRS invests in collateralized mortgage obligations (CMOs) which are mortgage-backed securities. These securities are based on cash flows from interest and principal payments on underlying mortgages. Therefore, they are sensitive to prepayments by mortgagees, which may result from a decline in interest rates. The CMOs held were issued by quasi-U.S. governmental agencies. There were no CMOs held at June 30, 2002 and June 30, 2001. The TCRS also invests in various asset-backed securities, representing ownership interests in trusts consisting of credit card or auto loan receivables. These securities are issued by organizations with AAA or AA credit ratings.

(continued)

TCRS invests in these securities primarily to enhance returns by taking advantage of opportunities available in this sector of the securities markets.

During Fiscal Year 2001, the TCRS purchased commercial paper issued by Pacific Gas and Electric Company (PG&E) which was due to mature at $25,994,000. PG&E defaulted on the maturity payment and filed for reorganization under Chapter 11 of the U.S. Bankruptcy Code. As of the date of the issuance of the TCRS financial statements, the TCRS continued to hold the PG&E commercial paper and the reorganization plan was still pending.

E. COMMITMENTS

Standby Commercial Paper Purchase Agreement - The TCRS has agreed to serve as standby commercial paper purchaser for commercial paper issued by the Funding Board of the State of Tennessee. By serving as a standby commercial paper purchaser, the TCRS receives an annual fee of 7.5 basis points on the $250 million maximum issuance under this agreement during times when both Moody's and Standard and Poor's investment ratings assigned to the State of Tennessee's general obligation bonds are Aaa and AAA respectively, and 12 basis points during times when either Moody's or Standard and Poor's has assigned ratings other than Aaa and AAA respectively. In the unlikely event that the TCRS would be called upon to purchase the commercial paper, the TCRS would receive interest at a rate equal to prime plus 75 basis points during the first 30 consecutive days, plus an additional 50 basis points for each consecutive 30 days thereafter, up to a maximum rate allowed by state law.

SCHEDULES OF FUNDING PROGRESS

Expressed in Thousands

	Actuarial Valuation Date	Actuarial Value of Plan Assets (a)	Actuarial Accrued Liability (AAL) Frozen Entry Age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Annual Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
SETHEEPP	7/1/01	$ 20,760,989	$ 20,842,216	$ 81,227	99.61%	$ 4,451,452	1.82%
	7/1/99	18,327,133	18,420,156	93,023	99.49%	4,132,409	2.25%
	6/30/97	15,671,678	15,782,850	111,172	99.30%	3,810,231	2.92%
PSPP	7/1/01	3,187,990	3,528,137	340,147	90.36%	1,545,593	22.01%
	7/1/99	2,690,781	2,890,942	200,161	93.08%	1,341,363	14.92%
	6/30/97	2,226,891	2,287,904	61,013	97.33%	1,130,585	5.40%

The SETHEEPP is comprised of a number of employee groups. However, the unfunded liability of $81.2 million at July 1, 2001 is attributable to two employee groups: 1) County Officials employed prior to July 1, 1972 and 2) State Judges and Attorneys General employed prior to July 1, 1972. The PSPP represents 404 participating entities at July 1, 2001. The unfunded liability of $340.1 million is attributable to 318 of the 404 entities.

See accompanying Notes to Required Supplementary Information

SCHEDULES OF EMPLOYER CONTRIBUTIONS

Expressed in Thousands

	SETHEEPP		PSPP	
Year Ended June 30	Annual Required Contribution	Percentage Contributed	Annual Required Contribution	Percentage Contributed
2002	$ 243,498	100%	$ 103,374	100%
2001	232,149	100%	103,681	100%
2000	252,162	100%	82,749	100%
1999	244,453	100%	69,230	100%
1998	166,756	100%		

An actuarial valuation of the TCRS is performed every two years with the next valuation scheduled to be effective July 1, 2003. The June 30, 1995 valuation determined the employer contribution rate for the year ended June 30, 1997 for the SETHEEPP and the PSPP, and for the year ended June 30, 1998 for the PSPP. Therefore, the Schedule of Employer Contributions, in accordance with the parameters of GASB Statement Number 25, is not available for the year ended June 30, 1997 for either plan or for the year ended June 30, 1998 for the PSPP.

See accompanying Notes to Required Supplementary Information

The information presented in the required supplementary schedules was determined as part of the actuarial valuations at the dates indicated. Additional information as of the July 1, 2001 actuarial valuation follows.

	SETHEEPP	PSPP
Valuation Date	July 1, 2001	July 1, 2001
Actuarial cost method	Frozen Entry Age	Frozen Entry Age
Amortization method	Level Dollar	Level Dollar
Remaining amortization period	14 years closed period	(1) closed period
Asset valuation method	5-year Moving Market Average	5-year Moving Market Average
Actuarial assumptions:		
Investment rate of return	7.50%	7.50%
Projected salary increases	4.75% (3)	4.75% (3)
Includes inflation at	(2)	(2)
Cost-of-living adjustments	3.00%	3.00%
Increase in Social Security wage base	3.50%	3.50%

(1) The length of the amortization period varies by political subdivision. For political subdivisions entering the plan on or after July 1, 1994, the amortization period does not exceed 20 years.

(2) No explicit assumption is made regarding the portion attributable to the effect of inflation on salaries.

(3) Uniform rate that approximates the effect of a graded salary scale.